MOODY'S
INVESTORS SERVICE

CREDIT OPINION
1 July 2016

Update

Rate this Research

RATINGS

North Shore Gas Company

Domicile	Chicago, ILLINOIS, United States
Long Term Rating	A2
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Natividad Martel, CFA 212-553-4561
VP-Senior Analyst
natividad.martel@moodys.com

Lesley Ritter 212-553-1607
Analyst
lesley.ritter@moodys.com

Michael G. Haggarty 212-553-7172
Associate Managing Director
michael.haggarty@moodys.com

North Shore Gas Company

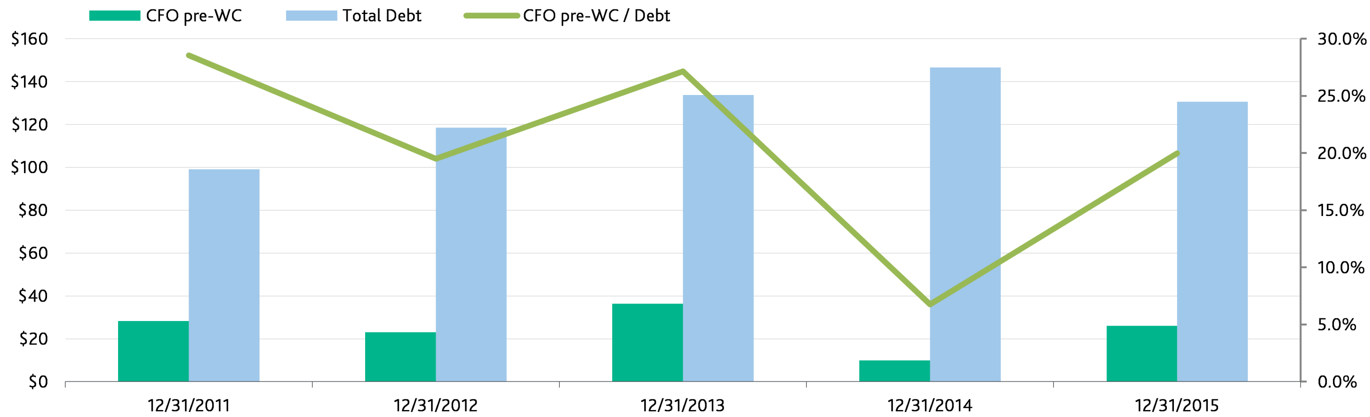
Regulated Local Distribution Company (LDC) in Illinois

Summary Rating Rationale

The A2 Issuer ratings and stable rating outlooks of The Peoples Gas Light and Coke Company (PGL) and North Shore Gas Company (NSG) are driven by their low business risk profile and a fairly credit supportive regulatory environment. The LDCs can borrow and loan up to $50 million from each other which supports the entrenchment of their ratings. The Issuer ratings also factor in our expectation that these issuers' key credit metrics will remain commensurate with the A-rating category. In the case of PGL this expectation is based on the continuation of a prudent corporate financing strategy in terms of increased leverage to help fund the Accelerated Main Replacement Program (AMRP) coupled with very limited dividend distributions.

PGL's Issuer rating is tempered by the challenging political environment within which the company has historically operated. That said, we acknowledge that changes in the management of the LDC's interactions with the local stakeholders and in the implementation of the AMRP-program upon the completion of WEC Energy Group's acquisition of the LDCs parent company, Integrys Holding, Inc (A3 stable) which have helped to improve PGL's relationship with the local authorities. Furthermore, the settlement agreement reached in May 2016 with the Illinois Attorney General and approved by the Illinois Commerce Commission (IIC) is also viewed as credit positive. The limited size of NSG's operations temper its Issuer rating. Both of these LDC Issuer ratings further captures our expectation that their credit metrics will become well better positioned within the A-rating category driven by continued prudent corporate finance policies including modest PGL dividend distributions during its material capital expenditure (capex) program.

Exhibit 1
Historical CFO Pre-WC, Total Debt, and CFO Pre-WC to Debt
($ in millions)



Source: Moody's Investors Service

Credit Strengths

» Fairly credit supportive regulatory environment

» Cash flow predictability enhanced by decoupling and a suit of rider mechanisms

» Financial performance in line with A-rating category

Credit Challenges

» NGL's limited size; the liquidity arrangements with PGL drive their ratings entrenchment.

» PGL operates in a challenging political environment but Settlement Agreement with the Illinois AG is a credit positive

» Significant permitting and paving costs; however, improved management of the implementation of AMRP and of the relationship with the City is reducing their impact on the LDC's O&M expenses

Rating Outlook

PGL and NSG's stable outlooks reflect an expectation of ongoing regulatory credit supportiveness and prudent financial policies (including limited dividend distributions) as the utilities execute on their capex programs. The stable outlooks assume their credit metrics will become better positioned within the A-rating category. Specifically, that PGL's Retained Cash Flow (RCF) to debt remains above 17% on a sustainable basis. In the case of NSG, the stable outlook reflects expectation that it will able to record 3-year CFO pre-W/C to debt and 3-year RCF to debt in excess of 19% and 15%, respectively.

Factors that Could Lead to an Upgrade

Upward rating pressure for PGL could be triggered by a material improvement in the political climate and/or regulatory environment within which the utility operates such that the utility is able to record a sustained amelioration in its metrics. Specifically, if its CFO pre-W/C to debt exceeds 26% on a sustained basis. NSG could see upward rating pressure if it were to see a significant improvement in financial metrics such that the ratio of CFO pre-W/C to debt exceeds 25% on a sustained basis.

Factors that Could Lead to a Downgrade

A deterioration in the credit supportiveness of the regulatory framework and/or heightened political interference that results in unanticipated additional capex requirements and/or challenges to the LDCs' ability to recover costs and/or capex and/or regulatory assets. A more aggressive dividend policy than currently anticipated would also likely trigger negative pressure on the rating or outlook, particularly if these circumstances negatively affected the financial performance of PGL and NSG. Specifically, if PGL's 3-year ratio of RCF to debt fell below 17% for an extended period, and NSG's 3-year CFO pre-WC to debt declined below 20%, on a sustained basis.

Key Indicators

Exhibit 2

KEY INDICATORS [1]

North Shore Gas Company -Private

	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011
CFO pre-WC + Interest / Interest	8.1x	3.4x	10.2x	6.1x	6.9x
CFO pre-WC / Debt	20.0%	6.8%	27.2%	19.5%	28.6%
CFO pre-WC – Dividends / Debt	14.2%	6.8%	18.2%	11.1%	19.1%
Debt / Capitalization	38.8%	42.2%	41.1%	40.5%	37.7%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Investors Service

Detailed Rating Considerations

FAIRLY CREDIT SUPPORTIVE REGULATORY ENVIRONMENT

The natural gas distribution operations of PGL (total rate base: $1.8 billion) and NSG (total rate base: $0.2 billion) are regulated by the Illinois Commerce Commission (ICC), while PGL's smaller natural gas storage and transmission activities are subject to FERC oversight.

The ICC provides a generally credit supportive cost recovery construct for LDCs operating within its regulatory jurisdiction. Our view considers the applications of a forward test year, a full decoupling mechanism, a one-for-one fuel cost pass-through based on monthly adjustments, a bad debt rider, and an immediate recovery of environmental cleanup costs. Importantly, in 2013 PGL secured a new legislative surcharge, the Qualifying Infrastructure Plant (QIP) Rider, to support until 2023 a timely cash recovery of the sizeable investments associated with the Accelerated Main Replacement Program (AMRP). The purpose of this 20-year program which started in 2011 is to accelerate the replacement in Chicago of cast iron and ductile iron pipes with steel and polyethylene pipes. This program accounts for the bulk of PGL's planned investments and explains the LDC's material increase in capex since 2014. The filings are made on a monthly basis which further reduces recovery-lag. That said, this recovery-mechanism is subject to certain limits including a 4% annual average hike of base rates and increases in total revenues not to exceed 5.5% in any given year. As a result, PGL plans to invest up to $280 million per year which management anticipates should allow the related tariff increase to fall within these annual surcharge-growth limits. This is a credit positive particularly considering that the two LDCs are currently operating under a two-year base rate freeze period, one of the key provisions imposed for the approval of WEC's acquisition of the Integrys group in June 2015. Nevertheless, upon expiration of this stay-out clause the LDCs anticipate that the requirement to file for a rate case will be limited upon successful implementation of additional cost saving initiatives.

Since the beginning of the decade, PGL and NSG have filed four rate cases. As is typical for Illinois utility rate cases, PGL and NSG's rate cases were fully litigated and decided within 11 months in accordance with the ICC's mandate. The 2014 rate order, like the 2013 order, kept the LDC's allowed ROE significantly below the national average and resulted in a decrease in allowed ROE to 9.05% from 9.28%. That said, we acknowledge that the predictability of the two LDCs' cash flows benefits from the combination of the fixed charge and surcharge components embedded in their rates as well as the decoupling mechanism which covers residential and small commercial and industrial customers. As a result, we understand that basically 100% of the two LDC's margin revenues generated from these two end-users segments are fixed. This percentage drops to 60% (PG) and 72% (NSG) for large commercial and industrial customers, respectively, but it still compares well with other LDCs' margin structure.

OPERATIONS IN A POLITICAL CHALLLENGING ENVIRONMENT BUT RECENT DEVELOPMENTS ARE CREDIT POSITIVE

The A2 Issuer ratings are capped by our opinion that the LDCs operate in a political challenging environment, particularly in the City of Chicago. Our opinion considers, for example, the investigation initiated last year by the Illinois Attorney General (AG) and the ICC following allegations that PGL had misled regulators about the costs of the AMRP. In 2009, PGL had estimated that the AMRP would cost about $2.6 billion, but in 2012 it revised its estimate up to almost $4.5 billion while the project's lead project manager (later dismissed) increased the estimated cost to over $8 billion in early 2015 in the midst of WEC's acquisition process. In May 2016, the AG signed settlement agreements with PGL and Integrys for $18.5 million. This resolved for then the cost of the AG's ($11 million) and ICC's ($7.5 million) investigations. Importantly, following the completion of WEC's acquisition the group introduced significant changes to better manage the implementation of the AMRP initiatives but also to improve PGL's relationship with various stakeholders in Chicago, including the City government. As a result, we note that during 2015 PGL was able to report a significant drop in its operational and maintenance (O&M) costs (2015: $404.1 million). This had soared significantly during 2014 ($488.5 million) compared to 2013 ($419.2 million) largely as a result of higher permitting and paving unit costs. This cost saving initiatives reduce the effect on PGL's constrained cash flows due to the ongoing 2-year rate freeze and cuts the rate case filing requirements to recover these O&M costs. Moreover, it also helped the LDC to record last year an actual RoE of 9.4% (2014: 5.3%; 2013: 8.8%) which compares well with the authorized 9.05% RoE, another credit positive. In our opinion, maintaining a constructive relationship with the local authorities is important from a credit perspective because the bulk of the LDC's riders and decoupling mechanisms are subject to reconciliation and prudency reviews.

FINANCIAL PERFORMANCE ON LOWER END OF THE A2 RATING SPECTRUM

During 2015, NSG's key credit metrics also improved significantly following the significant financial deterioration recorded the year before. Although proportionally smaller than PGL's planned investments, NSG's capex is expected to prevail at the high existing levels; however, we anticipate that its key credit metrics will benefit from additional cost reduction initiatives, modest dividend distributions and prudent debt incurrence to fund capital requirements. Thus, the A2 rating anticipates the LDC will be able to record key credit metrics that that are more in line with the utility's A2 rating according to the guidelines provided for the Low Business Grid under Moody's Regulated Electric and Gas Utility methodology published in December 2013. Specifically, we anticipate that the utility will record interest coverage, CFO pre-W/C to debt, and RCF to debt in excess of 4.5x, 19% and 15%, respectively.

Liquidity Analysis

PGL's P-1 Commercial Paper Program is backed-up by the LDC's separate $350 million committed credit facility that will mature in 2020. This is not subject to any conditionality including an ongoing material adverse change clause. The revolving credit facility includes a sole financial covenant; namely, to maintain a maximum debt to capitalization of 65%. The company has substantial headroom under the capital structure covenant. At the end of March 2016, PGL had $4 million outstanding under its commercial paper program (December 2015: $122.7 million) and recorded around $1.7 million of cash (December 2015: $6.6 million). PGL has the ability to borrow up to $150 million from Integrys (which has a $400 million revolving line of credit from WEC) and up to $50 million from NSG. That said, it had no outstanding under these arrangements at the end of March and December 2015.

Following the maturity of PGL's $50 million First Mortgage Bond (FMB) in November 2016 this year PGL's next most significant debt maturity is a $75 million First Mortgage Bond (FMB) due in 2019. We anticipate that the utility will be able to meet its capital requirements, largely consisting of capex (2016:$355 million), using a combination of internally generated cash flows (2015 CFO: $358 million), debt issuance and equity contributions when required. This also considers that since 2013 PGL has not paid out any dividends and our expectation of negligible dividends being paid over the foreseeable future.

NSG's liquidity is also considered adequate. The company has little cash on its balance sheet and does not have its own revolving credit facility or commercial paper program. However, it has the ability to loan or borrow up to $50 million from PGL and $50 million from Integrys. As of 31 December 2015, NSG had $28.8 million of short-term debt outstanding from PGL and no borrowings outstanding with Integrys. We anticipate that NSG will be able to meet its capital requirements, including capex (2016: $20.44 million) and dividends (2015: $8 million) largely using its internally generated cash flows (funds from operations in 2015: $27 million) and modest use of short-term debt. NSG's next debt maturity is in 2027 when a $28 million FMB will become due.

Other Considerations

As mentioned earlier, Moody's evaluates the financial performance of PGL and NSG relative to the standard and low business risk option under the updated Regulated Electric and Gas Utility Methodology published in December 2013. The difference is largely driven by our opinion that the implementation of PGL's capex program, particularly its AMRP in Chicago, is significantly more challenging than similar programs implemented by other rated LDCs across the US. As depicted in the grid below the companies' indicated ratings based on historical and projected credit metrics are A3, respectively, that is one notch below their currently assigned Issuer rating.

Corporate Profile

The Peoples Gas Light and Coke Company (PGL: A2 Issuer Rating, stable outlook) and North Shore Gas Company (NSG: A2 Issuer Rating, stable outlook) are two regulated Local Distribution companies (LDC) operating in Illinois. With a customer base of approximately 833,400 customers through its 4,670-mile distribution and transportation system serving the city of Chicago PGL is substantially larger than its sister company. NGS also stores, distributes, sells and transports natural gas to approximately 159,000 customers through a 2,430-mile distribution and transmission system serving 54 communities in northeastern Illinois.

The LDCs' client base make-up consists of a mix of residential, commercial, industrial and transportation customers. Transportation customers acquire their gas from third parties and pay the LDCs for the use of its distribution system.

WEC Energy Group (WEC; A3 stable) and Integrys Holdings, Inc (A3 stable) are PGL's and NSG's ultimate and intermediate parent holding companies, respectively, following the completion on June 29, 2015 of WEC's leveraged acquisition of Integrys Energy Group. PGL and NSG rank as the third and fifth largest utility subsidiaries of WEC with recorded gross margin for the last twelve month (LTM) period ended March 31, 2016 of almost $730 million and $96 million, respectively. We calculate that they represent around 17% and 2% of WEC's consolidated gross margin. Their sister companies include the regulated electric utilities Wisconsin Electric Power Company (Wepco; A1 negative), Wisconsin Public Service Corporation (WSPC; A1 negative) as well as the LDC Wisconsin Gas Company (A1 negative). These accounted over 57%, 21% and 6% of WEC's consolidated gross profit at the end of March 2016.

Rating Methodology and Scorecard Factors

Exhibit 3

Rating Factors				
North Shore Gas Company -Private				
Regulated Electric and Gas Utilities Industry Grid [1][2]	**Current FY 12/31/2015**		**Moody's 12-18 Month Forward View As of Date Published [3]**	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	A	A	A	A
b) Consistency and Predictability of Regulation	A	A	A	A
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	Aa	Aa	Aa	Aa
b) Sufficiency of Rates and Returns	Baa	Baa	Baa	Baa
Factor 3 : Diversification (10%)				
a) Market Position	A	A	Ba	Ba
b) Generation and Fuel Diversity	N/A	N/A	N/A	N/A
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	7.2x	Aa	6x - 8x	Aa
b) CFO pre-WC / Debt (3 Year Avg)	17.6%	Baa	13% - 22%	Baa
c) CFO pre-WC – Dividends / Debt (3 Year Avg)	12.8%	Baa	9% - 17%	Baa
d) Debt / Capitalization (3 Year Avg)	40.7%	A	35% - 45%	A
Rating:				
Grid-Indicated Rating Before Notching Adjustment		A3		A3
HoldCo Structural Subordination Notching		0	0	0
a) Indicated Rating from Grid		A3		A3
b) Actual Rating Assigned		A2		A2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 12/31/2015
[3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
NORTH SHORE GAS COMPANY	
Outlook	Stable
Issuer Rating	A2
Senior Secured MTN	(P)Aa3
ULT PARENT: WEC ENERGY GROUP, INC.	
Outlook	Stable
Issuer Rating	A3
Senior Unsecured	A3
Jr Subordinate	Baa1
PARENT: INTEGRYS HOLDING, INC.	
Outlook	Stable
Issuer Rating	A3
Commercial Paper	P-2
PARENT: INTEGRYS ENERGY GROUP, INC.	
Outlook	No Outlook
Senior Unsecured	A3
Jr Subordinate	Baa1

Source: Moody's Investors Service

REPORT NUMBER 1033803

MOODY'S INVESTORS SERVICE